No. 18628

In the United States Court of Appeals for the Ninth Circuit

WILL FLITCROFT AND AGNES D. FLITCROFT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

JOHN B. JONES, Jr.,
Acting Assistant Attorney General,
MEYER ROTHWACKS,
EARL J. SILBERT,
Attorneys,
Department of Justice,
Washington, D.C., 20530.

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 217–247) are reported at 39 T.C. 52.

JURISDICTION

This petition for review (R. 262–266) involves federal income taxes for the taxable years 1954, 1955 and 1956. On March 11, 1959, the Commissioner of Internal Revenue mailed to taxpayers a notice of deficiency for the taxable years 1953 and 1954 in the sum of $76,240.81. (R. 16–24.) Within ninety days thereafter and on May 4, 1959, the taxpayers filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213(a) of the Internal Revenue Code of 1954. (R. 9–15.) On

August 5, 1960, the Commissioner of Internal Revenue mailed to taxpayers a notice of deficiency for the taxable years 1955 and 1956 in the sum of $56,713.74. (R. 36–41.) Within ninety days thereafter and on September 6, 1960, taxpayers filed a petition with the Tax Court for redetermination of that deficiency under the provisions of Section 6213(a) of the Internal Revenue Code of 1954. (R. 31–35.) At the Tax Court hearing the cases were consolidated for trial, briefing, and opinion. (R. 70.) The decision of the Tax Court for the years 1953 and 1954 was entered on December 18, 1962. (R. 258.) The decision of the Tax Court for the years 1955 and 1956 was entered on December 20, 1962. (R. 260.) The case is brought to this Court by a petition for review filed March 11, 1963. (R. 262–266.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Was the income of three short-term trusts set up by taxpayers in behalf of their minor children includible in taxpayers' gross income under the provisions of Section 673(a) of the Internal Revenue Code of 1954?

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations may be found in the Appendix, *infra*.

STATEMENT

The facts as found by the Tax Court (R. 218–233) may be summarized as follows:

Taxpayers, Will and Agnes Flitcroft, reside in Los Angeles County, California. They first became associated with a partnership known as Western Hydraulic & Service Company (hereinafter referred to as Western Hydraulic) on November 1, 1945, when they and two other persons executed a partnership agreement under which each became a partner with a 25 percent interest in the partnership. The partnership was formed for the manufacture and assembly of hydraulic parts, assemblies, and fittings, general machine shop work, manufacturing work, and the servicing of hydraulic parts, assemblies, and fittings. The duties of Will Flitcroft in the partnership consisted of managing the plant facilities and supervising production, and the duties of one of the other partners consisted of contacting customers and selling partnership products. The duties of Agnes D. Flitcroft under this agreement were not specified. (R. 218–219.)

On April 1, 1946, the partnership between taxpayers and their two partners terminated and on the same date taxpayers purchased the partnership interest of the other two partners and formed a new partnership in which each owned a 50 percent interest. During the years 1946 through 1952 taxpayers, as partners, operated the business of Western Hydraulic at a plant facility located at 70th and Central Avenue, Los Angeles, California, and subsequent to 1952 and until about November 12, 1953, the business of Western Hydraulic was operated at a plant facility located on West 136th Street in Gardena, California. The property at 70th and Central Avenue was owned

personally by Will Flitcroft and the partnership was permitted to use this property without a lease and without payment of rent therefor. Will Flitcroft managed the company, functioned as chief of quality control, did all of the purchasing of materials, machinery, and tools, did the bidding for customers, and kept up customer relations, as well as supervising production. In the performance of these duties Will Flitcroft worked long hours, six days and sometimes seven days a week. (R. 219–220.)

In June of 1952 Will Flitcroft became acquainted with Richard H. Miers (hereinafter referred to as Miers), when Miers was sent to the plant of Western Hydraulic by his employer (who was doing accounting work for the partnership) to make a running audit of the partnership's books. Subsequent to the time that Miers made this running audit Will Flitcroft terminated the services of the accounting firm by which Miers was employed, engaged and then discharged another certified public accountant to do the work for Western Hydraulic, and then about July, 1952, engaged Miers to keep the books and records of the partnership. The partnership paid Miers the prevailing fee of $60 per day for his services. (R. 220.)

After Western Hydraulic engaged Miers to render accounting services for it, Will Flitcroft and Miers discussed from time to time the advantages which taxpayers might derive through the creation of trusts for the benefit of their two minor children and the inclusion of these trusts in the partnership. On November 6, 1952, Miers wrote a letter to taxpayers sug-

gesting that the partnership, Western Hydraulic, composed of taxpayers, be dissolved on December 31, 1952, and that a new partnership be formed on January 1, 1953, composed of taxpayers and their two minor children, Johnel A. Flitcroft and William R. Flitcroft. (R. 220.)

Sometime in November, 1952, a meeting was held at taxpayers' home at which the taxpayers, their children, aged 10 and 12 years, Miers, and an attorney were present. The attorney who was present, Frederick L. Botsford, had been an acquaintance of Miers for some time and Miers had recommended him to Will Flitcroft. The result of the meeting held in November, 1952, was a decision to create a 10-year trust for each of taxpayers' minor children, to which trusts one-half of taxpayers' interest in Western Hydraulic was to be conveyed. A new partnership was to be formed that would be composed of taxpayers and the trusts for their two minor children. Miers was to be appointed sole trustee of the trusts because Will Flitcroft had confidence in him. An agreement dated December 31, 1952, dissolving the partnership, Western Hydraulic, was executed by taxpayers on a date not shown in the record. (R. 221.)

Sometime after January 1, 1953, taxpayers and Miers executed two agreements dated January 1, 1953, identical except as to the beneficiary named therein, each entitled "trust agreement" and each stating in part as follows (R. 221–222):

> This Trust Agreement is entered into between WILL FLITCROFT and AGNES DOROTHY

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> FLITCROFT, husband and wife, as the Trustors, and RICHARD H. MIERS, as the Trustee.
>
> The Trustors have transferred and delivered to the Trustee, without any consideration on their part, the property described in the attached "Schedule A", which is a part of this Trust Agreement, the receipt of which is hereby acknowledged by the Trustee. The said property, together with any other property that may later become subject to this Trust, shall constitute the trust estate, and shall be held, administered and distributed by the Trustee as provided herein.
>
> ARTICLE I
>
> The Trustors shall have the right at any time to add to this Trust other property acceptable to the Trustee, which additional property, upon its receipt and acceptance by the Trustee, shall become a part of the Trust estate.

Article 2 of the trust provided for broad powers of management of the trust corpus by the trustee. Article 3 provided for the accumulation by the trustee of the net income of the trust during the term of the trust, except that under certain circumstances, in the absolute discretion of the trustee, payment of all or a portion of the income could be made to the beneficiary of the trust. It also provided that the trust should cease and terminate on January 6, 1963; that upon termination the trustee should pay to the beneficiary the net income of the trust estate then remaining and should deliver and return to the trustors all of the property then remaining that they had transferred and delivered under the trust to the trustee and

any property then in the hands of the trustee which had been acquired by him from the sale or other disposition of the property transferred and delivered to him by the trustors. Article 4 provided that the beneficiary should have no right to alienate his or her interest in the trust. Articles 5 and 6 provided for the appointment of a successor trustee should the trustee resign and for the fees to be paid to the trustee. Article 7 of the trust agreement provided as follows (R.222):

> This Trust has been accepted by the Trustee and will be administered in the State of California, and its validity, construction and all rights thereunder shall be governed by the laws of that State. If any provision of this Trust Agreement should be invalid or unenforceable, the remaining provisions thereof shall continue to be fully effective.

Attached to each of the trust agreements was a statement of the assets, liabilities, and net worth of the partnership, Western Hydraulic, as of December 31, 1952. (R. 223.)

At the same time that the trust agreements were executed taxpayers and Miers (as trustee for each of the two trusts) executed an agreement entitled "agreement of partnership", which agreement stated that it was made the first day of January, 1953, and provided that the name of the partnership should be Western Hydraulic and Service Company and that the terms of the partnership should begin on January 1, 1953, and should end on December 31, 1963. It provided that the capital contribution should consist of the assets subject to the liabilities (as shown

on an attached statement of assets and liabilities), and further provided that the assets should belong to each of the parties equally. To do this each of the parties assigned to the others an undivided equal one-fourth interest of the assets shown on the attached statement. The capital contribution of each partner was to consist of his or her interest in the assets (subject to liabilities) of the agreed net value of $315,530.01 in which each partner owned an undivided one-fourth interest. (R. 223–224.)

The partnership agreement also provided that Will Flitcroft should be general manager of the partnership at a minimum salary of $25,000 a year, to be paid from the partnership funds, and that Agnes D. Flitcroft should at all times make her services available to the partnership for secretarial work at a minimum salary of $3,000 per year. Net profits or losses after the payment of salaries to taxpayers were to be divided equally among the partners and the account of each credited or debited with his or her proportionate share thereof. Any party might withdraw his or her share of the net profits at the end of any year and any profits not withdrawn were to bear interest at the rate of 6 percent. The death of a party or a beneficiary of one of the trusts would not terminate the partnership, but the partnership would continue for the then remaining unexpired term, and the personal representative of the deceased would receive the deceased person's interest in the partnership and his or her share of the net profits or losses. (R. 224.)

On May 12, 1954, a certificate of business fictitious Firm Name was filed in the office of the county clerk

of Los Angeles County, California, in which it was stated that the firm of Western Hydraulic was composed of the following persons: Will Flitcroft, Agnes Dorothy Flitcroft, and Richard H. Miers, as trustee for William R. Flitcroft and Johnel Ann Flitcroft. (R. 225.)

Capital was a material income-producing factor in the partnership, Western Hydraulic. (R. 225.)

Taxpayers were motivated, in executing the trusts for their two minor children and the partnership agreement with Miers as trustee of each of these trusts, by a desire to save taxes (part of the anticipated partnership income distributable to the trusts), a desire to create a separate estate for their children, a desire to have the share of the profits attributable to the two trusts remain for use in the partnership business, and a desire to interest the children in the business of the partnership as they matured in years. (R. 225.)

Will Flitcroft had also concluded that it would be advantageous to have Miers do the accounting work for Western Hydraulic and to help operate the business. During the years 1953 through 1956 Miers spent most of his time in connection with the business of Western Hydraulic. He took charge of production control, accounting, contract negotiations, renegotiation of Government contracts, and cost records. He also handled labor relations for the partnership and served as its controller, as well as working with the sales and engineering departments on the submission of bids for contracts. He hired office personnel and dealt directly with customers of Western Hydraulic.

During the years 1953 through 1956 Miers was paid a fee of $60 per day or approximately $900 per month for the services he rendered Western Hydraulic. (R. 225–226.)

Sometime in 1953 or prior thereto Will Flitcroft recognized that the premises then occupied by Western Hydraulic had become too small for the operation in which the company was then engaged. In March or April, 1953, taxpayers acquired a 60 percent interest in a parcel of real estate known as 1510 West 135th Street, Gardena, California. The owners of the other 40 percent interest in this property were John O. Best and his wife. Will Flitcroft sold the building he owned at 70th and Central Avenue, Los Angeles, California, which was occupied by Western Hydraulic, and a factory building suitable for use by Western Hydraulic was built on the property on West 135th Street acquired by taxpayers and the Bests. Western Hydraulic moved into this new building upon its completion about November 1, 1953. On September 15, 1953, a lease agreement was executed between taxpayers and the Bests as lessors and Western Hydraulic as lessee, under the terms of which it was agreed that Western Hydraulic would lease the improved property for a period of 10 years commencing October 1, 1953, and terminating September 30, 1963, for a monthly rental of $1,600, of which Western Hydraulic would pay $960 to taxpayers and the remaining $640 to the Bests. (R. 226.)

On or about October 1, 1953, taxpayers and Miers executed an agreement dated October 1, 1953, entitled "trust agreement", naming taxpayers' two minor chil-

dren as beneficiaries. The provisions of this trust agreement, except as to the named beneficiaries and commencement and termination dates, were the same as those of the two separate trusts dated January 1, 1953, created by taxpayers for their two minor children. Under date of October 1, 1953, taxpayers conveyed, by quitclaim deed, their 60 percent interest in the property at 1510 West 135th Street, Gardena, California, to Miers as trustee, and also assigned their interest as lessors under the lease of the premises to the trust. The trust, as stated in the trust agreement, was to terminate on October 6, 1963. (R. 226–227.)

On January 1, 1957, the business of Westren Hydraulic was incorporated. At the time of incorporation, each of the trusts dated January 1, 1953, received 5,000 shares of stock of the corporation, such shares having a total value of $120,000, and in addition each trust received $70,000 of notes of the new corporation. (R. 227.)

On April 15, 1954, taxpayers, individually, filed federal gift tax returns for the year 1953, which are identical except as to the name of the taxpayer, each return indicating that the filer thereof made two gifts during the year totaling $31,633.94, comprising the stated $22,954.81 "gift" to the trusts stated to have been created on January 1, 1953, and the $8,679.13 "gift" stated to have been made to the trust created on October 1, 1953. (R. 227.)

Taxpayers also filed gift tax returns with the State of California for the year 1953, reporting thereon gifts made to each of their children in trust, in the

total amount of $35,268.69. (R. 227.) Under date of June 29, 1954, taxpayers' attorney received a letter from the office of the Controller of the State of California, Chief Inheritance Tax Attorney (R. 227–228), which stated (R. 228):

> We have examined the trusts executed by the above named donors * * * [taxpayers], and are wondering whether at the time of the execution, they had in mind Section 2280 of the Civil Code.
>
> It appears to us that in view of this section, the trusts are revocable, and that no gift tax is due. May we have your thoughts on this point?

Under date of July 21, 1954, taxpayers' attorney replied to this letter as follows (R. 228):

> When the trusts were prepared and executed by the Donors * * * [taxpayers] consideration was not given to the effect of Section 2280 of the Civil Code.
>
> It was and is the intention of the Donors * * * [taxpayers] that the Trusts should be irrevocable and therefore I will prepare and have signed by them (and furnish you with a true copy), an amendment to the Trust Indentures making the Trusts irrevocable and waiving any rights the Donors * * * [taxpayers] might have to revoke the same under said Section 2280.
>
> I trust this will remedy the situation and the Trusts will then qualify for gift tax purposes.

Taxpayers and Miers executed an amendment, dated July 30, 1954, to each of the three trust agreements, which provided as follows (R. 228–229):

> WHEREAS, it has been called to the attention of the trustors that, under Section 2280 of the Civil Code of the State of California, said trust may be revocable because it is not by its terms made expressly irrevocable; and
>
> WHEREAS, it was, always has been and is the expressed intention of First Parties * * * [taxpayers] that said trust should be irrevocable.
>
> NOW, THEREFORE, IT IS MUTUALLY AGREED between the parties hereto as follows:
>
> There is hereby added to Article 7 on Page 4 thereof the following:
>
> This trust is by the trustors, hereby expressly made irrevocable.

Under date of September 10, 1954, the office of the Controller of the State of California, Inheritance and Gift Tax Division, issued a Notice and determination of gift tax, determining that each taxpayer made net taxable gifts to each of their children in the year 1953 in the total amount of $35,268.69. (R. 229.)

Taxpayers, Miers and Frederick L. Botsford executed an amendment to the trust agreement dated December 1, 1954, whereby Botsford became the cotrustee with Miers for the three trusts. Miers, as trustee of the two individual trusts, consulted with taxpayers as to the management of Western Hydraulic. In addition Miers, as trustee and cotrustee of each of the three trusts, kept the books and records for the trusts, prepared and filed federal and State of California fiduciary income tax returns for the trusts, and prepared and signed checks for income taxes and trustees' fees on behalf of the trusts. Botsford's acts as co-

trustee for each of the three trusts were limited to legal matters connected with the trusts. Separate bank accounts and capital accounts were kept for each of the three trusts. Taxpayers have never received any income from the trusts. (R. 230.)

On or about November 7, 1958, Botsford and Miers, as trustees of the Flitcroft trusts, and taxpayers' two minor children by a guardian *ad litem*. filed a complaint in the Superior Court of the State of California in and for the County of Los Angeles against taxpayers and Robert A. Riddell, District Director of Internal Revenue, requesting that a declaratory judgment be entered, declaring and adjudicating the respective rights of the plaintiffs and defendants pertaining to the written instruments attached thereto (the two documents entitled "trust agreement" dated January 1, 1953, together with amendments thereto). The complaint stated that the defendant Robert A. Riddell, District Director of Internal Revenue, had refused to recognize the amendments to trust agreements executed on or about July 30, 1954, as being effective, and had refused to recognize that the trust agreements dated January 1, 1953, constituted irrevocable trusts. The defendant Robert A. Riddell petitioned for removal of the action brought against him to the United States District Court for the Southern District of California, Central Division, which petition was granted, and the action against Riddell was dismissed by the District Court. Upon appeal, the dismissal was affirmed by the United States Court of Appeals for the Ninth Circuit, *Botsford* v. *Riddell,* 283 F. 2d 298. After the affirmance the remaining

parties stipulated and agreed that the matter should be remanded to the Superior Court of the State of California in and for the County of Los Angeles for further proceedings. (R. 230–231.) On November 13, 1961, the Superior Court of the State of California in and for the County of Los Angeles entered the following order (R. 231):

> IT IS ORDERED, ADJUDGED, AND DECREED that the Trust Agreements, dated January 1, 1953, executed by the defendants Will Flitcroft and Agnes D. Flitcroft, as trustors, and by the plaintiff Richard H. Miers, as trustee, copies of which are attached to the complaint on file herein marked as Exhibit A and B, be and they hereby are reformed in accordance with the express intent of the trustors and trustee so that the following sentence is added to the first paragraph of each of said Trust Agreements: "This Trust is irrevocable."
>
> IT IS FURTHER ORDERED AND DECREED that said Trust Agreements were irrevocable upon their date of execution, January 1, 1953, and the respective rights and obligations of the parties arising from said agreements shall be governed accordingly.

Western Hydraulic filed federal partnership returns of income for the calendar years 1954, 1955 and 1956, reporting its income and deductions on an accrual basis of accounting. On the partnership return for the year 1954 there was reported a loss on the sale of land and building located at 6920 South Central, Los Angeles, California. On the partnership returns of income of Western Hydraulic for the years 1954, 1955, and 1956, ordinary net income was reported in

the amount of $114,658.52, $56,726.87, and $69,537.67, respectively. (R. 231–232.) The ordinary net income reported on the returns of Western Hydraulic was allocated thereon as follows (R. 232):

Name of partner	1954	1955	1956
Will Flitcroft	[1] $37,414.63	$14,181.72	$17,384.41
Agnes D. Flitcroft	[1] 37,414.63	14,181.72	17,384.42
J. A. Flitcroft Trust	19,914.63	14,181.71	17,384.42
W. R. Flitcroft Trust	19,914.63	14,181.72	17,384.42
	$114,658.52	$56,726.87	$69,537.67

[1] These amounts include the $17,500 of salaries of taxpayer not included in the subsequent years.

Withdrawals were made from Western Hydraulic during the years 1954, 1955, and 1956 against the capital accounts of the trusts as follows (R. 232):

	Withdrawal from	
Year	*Johnel trust*	*William trust*
1954	$8,052.05	$8,052.05
1955	4,938.18	4,938.18
1956	1,614.32	1,609.93

The only expenditures made on behalf of the two trusts during the years 1954, 1955, and 1956 were for federal and State income taxes and trustees' fees, and in 1954 and 1955 for charitable contributions. Except for the amounts withdrawn, the partnership income allocated to the two trusts was credited to the capital accounts of these trusts on the partnership's books and kept in the business of the partnership as additional operating capital. (R. 232–233.)

Western Hydraulic claimed rental expense deductions on its federal partnership returns of income for the years 1954, 1955, and 1956 in the respective amounts of $22,392.83, $19,200, and $19,200, which

amounts were stated to have been paid as rental for the factory located at 1510 West 135th Street, Gardena, California. (R. 233.)

Each of the trusts created for taxpayers' children (individually) filed federal income tax returns for the year 1954 and subsequent years on a calendar year basis. The trust created for taxpayers' children (jointly) filed a federal income tax return for a fiscal year December 1, 1953, to December 1, 1954. (R. 233.)

The Commissioner of Internal Revenue in his notices of deficiency for the years 1954, 1955, and 1956 increased taxpayers' income in each year by including therein the total amount of the net income of the partnership, Western Hydraulic. In determining the net income of Western Hydraulic to be included in taxpayers' income, the Commissioner increased the amount of such income as reported on the partnership returns of income by 60 percent of the rental deduction for the factory at 1510 West 135th Street, Gardena, California, claimed by the partnership. In each instance the Commissioner disallowed the claimed deduction for rent on the ground that the amount claimed to be paid to the trust for taxpayers' minor son and daughter was not a deductible business expense of the partnership; and the Commissioner included the total income of the partnership in the taxpayers' taxable income on the ground that no recognition should be given to the trusts as partners for federal income tax purposes. (R. 233.) The Tax Court upheld the deficiencies as determined by the Commissioner. (R. 258–261.)

SUMMARY OF ARGUMENT

The only issue on this appeal is whether the income of the three trusts created by taxpayers in behalf of their two minor children is includible in taxpayers' gross income in the years 1954, 1955, and 1956. Under Section 673(a) of the Internal Revenue Code of 1954, a grantor of a trust who retains a reversionary interest is taxable on the income of the trust unless he irrevocably surrenders his right to the income of that trust for a period of at least 10 years. The three trusts in this case were created for periods of a few days in excess of 10 years, but because the trusts when created were revocable under California law, their income was taxable to the taxpayers-grantors.

Section 2280 of the Civil Code, 10 West's Annotated California Codes, provides that a voluntary trust—one created, under decisions of the California state courts, without consideration—is revocable unless the instrument creating it expressly provides that the trust is irrevocable. Since the three trusts here were voluntary and did not contain such a provision, they were revocable. The trusts were subsequently amended and made irrevocable, but at the time they were amended, they had less than 10 years to run. Consequently their income was includible in taxpayers' gross income.

Taxpayers argue that the trusts were not voluntary trusts because taxpayers created them to secure the services of the trustee Miers in their partnership business, and that therefore the trusts were for their own benefit, not for their children's. This argument hardly merits refutation; it strains credulity to be-

lieve that taxpayers would create the three trusts only as a means of obtaining the services of Miers in their business. Other ways of effecting that result certainly were both possible and preferable. The minimal compensation provided by the trusts for the trustee, the testimony of Will Flitcroft that he chose Miers as trustee because of Miers' interest in the children, the nature of the trusts themselves, and the fact that the trusts expressly state that they were created without consideration, all contradict taxpayers' argument and support the Tax Court's conclusion that these trusts were voluntary trusts created in behalf of taxpayers' children and therefore revocable.

Taxpayers also contend that the trusts were irrevocable for over ten years because of the state court judgment which reformed the trusts to make them irrevocable and which specifically made the reformation retroactive to the date the trusts were created. The state court judgment, however, was rendered seven years after taxpayers were informed that their trusts were revocable, at a time when the only important effect of the reformation would be on taxpayers' federal tax liability. In light of the additional significant fact that the state court judgment was rendered on the pleadings—without any hearing, despite an inconsistency between the complaint and the evidence known to the parties as to why the trusts did not contain the necessary phraseology of irrevocability—it is clear that the judgment was nothing more than a consent decree—collusive in fact—and therefore was not binding on the federal courts under decisions of this Court and other Courts of Appeals.

That the state court proceeding was instituted as an action for declaratory judgment, an action which under California law requires an actual controversy, is not significant here because the issue of actual controversy was never raised and because the evidence convincingly shows that there was no *bona fide* dispute between the parties. Finally, a reformation of the kind secured here, obtained long after the taxable years in question, cannot operate so as to defeat the rights of the Federal Government which had already accrued.

Nor is there any merit to taxpayers' contention that Section 673(a) of the 1954 Code and the corresponding Regulations promulgated under the Internal Revenue Code of 1939 are unconstitutional. Taxpayers rely on *Commissioner* v. *Clark,* 202 F. 2d 94 (C.A. 7th). This case is completely distinguishable from the instant case because in *Clark* the court specifically found that the trusts were 10 year trusts and because in *Clark* the Commissioner of Internal Revenue was applying the Regulations promulgated under the 1939 Code to trusts created prior to date of promulgation. In the instant case the Regulations had been in effect for seven years before the trusts were created.

Thus the statement of the Seventh Circuit that the Regulations and even a statute taxing grantors of reversionary trusts for less than 10 years are unconstitutional is mere dictum, a dictum which this Court should not follow. The so-called Clifford Regulations and the short-term trust provisions of the 1954 Code were passed after an invitation made by the Supreme

Court in *Helvering* v. *Clifford,* 309 U.S. 331, and repeated in *Harrison* v. *Schaffner,* 312 U.S. 579, to the Congress and the Treasury to provide precise, fixed rules in the area of the taxation of grantors of trusts short in duration and over which the grantors may also have retained a certain measure of dominion and control. The response of both the Congress and the Treasury taxing grantors of reversionary trusts lasting less than 10 years was not unreasonable. The period of time was not too long, particularly because several Courts of Appeals had already upheld the taxation of grantors of trusts lasting about 10 years. The automatic taxation of grantors of such trusts, instead of the prescription of a rebuttable presumption, as advocated by the Seventh Circuit, was in accord with the invitation of the Supreme Court in *Clifford* to lay down "precise" guidelines which would obviate the need for a case by case determination by the judiciary. Neither the statute nor the Regulations, in view of the leeway to be granted legislative and administrative judgment, should, therefore, be held unconstitutional.

ARGUMENT

The Tax Court correctly held that the income of the three trusts created for the benefit of their children was includible in taxpayers' gross income in the years 1954, 1955, and 1956

The only issue presented on this appeal is whether the Tax Court correctly held that the income of the three trusts created by the taxpayers for the benefit of their two minor children was includible in the tax-

payers' gross income in the years 1954, 1955, and 1956.[1]

Although these three trusts were created in 1953, the taxability of the income they received in 1954, 1955, and 1956 is, pursuant to Section 683(a) of the Internal Revenue Code of 1954, Appendix, *infra,*

[1] The income of the joint trust for the minor children consisted of rent paid to it by the partnership. The notices of deficiency from the Commissioner to the taxpayers did not include these rental payments in taxpayers' gross income but instead disallowed to the partnership the deduction it claimed for the rental paid to the joint trust. (R. 23, 37.) This disallowance, of course, increased the net income of the partnership and therefore increased the distributive share of the taxpayers-partners' own income. Section 701 and Section 702 of the Internal Revenue Code of 1954. In his opening brief in the Tax Court, the Commissioner adopted a new legal theory when he stated:

> The broad question presented for the Court's determination in these consolidated cases is whether partnership income reported by *three* trusts created by petitioners [taxpayers] for the benefit of their two children is taxable to petitioners in the years 1954, 1955, and 1956. (Emphasis supplied.)

Nowhere in his brief did the Commissioner attempt to justify the disallowance of the rental deduction to the partnership. In their reply brief in the Tax Court, taxpayers, strangely enough, did not discuss nor even mention the Commissioner's new theory.

In its opinion, the Tax Court recognized the Commissioner's new theory when it stated his position in the case exactly as he had stated it in his opening brief. (R. 234.) Moreover, in its opinion, it never discussed the correctness of the Commissioner's disallowance of the rental deduction in the notices of deficiency. Its decision upholding the deficiencies asserted by the Commissioner was clearly based on the inclusion of the rental payments to the joint trust in taxpayer's gross income, not on the disallowance to the partnership of the deductions for rental payments.

Nevertheless, in their brief in this Court, taxpayers have failed to acknowledge both the Commissioner's adoption of a

governed by the special trust provisions of the 1954 Code, except for the income earned by the joint trust in the fiscal year, December 1, 1953, to December 1, 1954, the taxability of which is governed by the Internal Revenue Code of 1939 and the Regulations promulgated thereunder.[2] The application of these

new theory and the Tax Court's acceptance of this theory with respect to the income of the joint trust and instead have challenged the disallowance of the deduction of the rental payments. (Br. 31, 56–59.) This challenge, however, is not responsive to the opinion and decision of the Tax Court. In adopting a new legal theory in his opening brief, the Commissioner sought only to uphold the deficiency he had asserted in the notices of deficiency on a different basis; he never made any attempt to increase the deficiency. Thus, instead of disallowing to the partnership the deductions for rent and thereby increasing both its net income and taxpayers' distributive share of this income, the Commissioner allowed the rental deduction to the partnership but included the rental payments to the joint trust in taxpayers' gross income. The resulting increase in taxpayers' gross income was the same as under the Commissioner's original theory; the only difference was the theory justifying the increase. All the facts relevant and material to this new theory were before the Tax Court in the exhibits and testimony, particularly because the question of whether the income of the joint trust was includible in taxpayers' gross income was similar to the question of whether the income of the other two trusts was includible in taxpayers' gross income. Consequently, taxpayers were not placed at any disadvantage by the Commissioner's adoption of a new theory and the Tax Court's acceptance of it. Accordingly, any complaint they may subsequently make, especially in light of their failure to complain to the Tax Court itself, is without merit. *Anderson* v. *Commissioner*, 156 F. 2d 591 (C.A. 2d); *Irish* v. *Commissioner*, 129 F. 2d 468 (C.A. 3d); *Moore* v. *Commissioner*, 202 F. 2d 45 (C.A. 5th).

[2] The pertinent provisions of the 1939 Code and the Regulations, however, are, for the purpose of this case, identical to the pertinent sections of the 1954 Code. Thus, compare Section 166

special trust provisions of the 1954 Code to income received by these pre-1954 trusts in 1954, 1955, and 1956 by Section 683(a) is valid, even as to that income received in 1954 prior to the enactment of the 1954 Code. *Reinecke* v. *Smith,* 289 U.S. 172, 175.

Under Section 673(a) of the 1954 Code, Appendix, *infra,* the income of a trust is taxable to the grantors if they retain a reversionary interest which may be expected to take effect in 10 years. The taxpayers in this case retained a reversionary interest in the trusts they created, but each of the trusts they created was to last for a few days in excess of 10 years. (Art. III (B), Exs. 5, 6, 20.) Taxpayers, however, are not therefore relieved of taxability under Section 673(a) because this provision must be correlated with Section 676(a), Appendix, *infra.* See H. Rep. No. 1337, 83d Cong., 2d Sess., p. A217 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4356); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 370 (3 U.S.C. Cong. & Adm. News (1954), 4621, 5012). Under this section, grantors of a trust are taxable on the trust's income if they have a power of revocation, unless, under Section 676(b), Appendix, *infra,* the power of revocation cannot be exercised for a period of time which would exempt them under Section 673. The net effect of these two sections, therefore, is that, for grantors to be nontaxable on the income of a trust under Section 673(a), they must have irrevocably surrendered all right to reinvest themselves with the income of the trust for

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of the 1939 Code, to Section 676(a) of the 1954 Code, and Treasury Regulations 118 (1939 Code), Sec. 39.22(a)-21(c)(i), to Section 673(a) of the 1954 Code.

a period of 10 years, an interpretation consistent with the Committee Reports which state (H. Rep. No. 1337, *supra,* p. 63 (3 U.S.C. Cong. & Adm. News (1954), p. 4089); S. Rep. No. 1622, *supra,* p. 87 (3 U.S.C. Cong. & Adm. News (1954), p. 4719):

> Under your Committee's bill, the grantor is not to be taxed by reason of a reversionary interest in an *irrevocable* trust unless the reversion may occur within 10 years. (Emphasis supplied.)

The question to be resolved in this case, accordingly, is whether the three trusts created by the taxpayers here were irrevocable for 10 years. The Tax Court held that they were *not.* Its holding, we submit, is correct and should be sustained.

Each of the three trusts involved in this case was by its terms to be administered in the State of California and its validity and construction governed by the laws of that State. (Exs. 5, 6, 20.) Section 2280 of the Civil Code, 10 West's Annotated California Codes, Appendix, *infra,* specifically provides that every voluntary trust shall be revocable by the trustor by a writing filed with the trustee unless expressly made irrevocable by the instrument creating it. Since none of the three trust instruments contained a provision expressly making them irrevocable (Exs. 5, 6, 20), under California law they were revocable trusts until amended to be irrevocable on July 30, 1954 (Exs. 7, 8, 21). At this time, however—July 30, 1954—none of the trusts had 10 years to run. Accordingly, though the trusts were irrevocable in the taxable years in question—1954, 1955, and 1956—the income of these trusts was taxable to taxpayers under Section 673(a)

because none of the trusts was or ever had been irrevocable for a period of 10 years, as that section requires.

Taxpayers offer several arguments against this conclusion. Examination of these arguments, however, reveals that they are without merit.

1. Taxpayers claim (Br. 40–48) that Section 2280 of the California Civil Code is not applicable to these trusts. The reason for this, taxpayers continue, is that when these trusts are considered together with the partnership agreement (Ex. 17), it becomes clear that they were created for taxpayers' own benefit and therefore were not voluntary trusts as defined in *Touli* v. *Santa Cruz County Title Co.*, 20 Cal. App. 2d 495, 67 P. 2d 404. The same contention has been raised by other taxpayers and has been specifically rejected by this Court which has held trusts similar to those in this case to be revocable under California law. *Newman* v. *Commissioner,* 222 F. 2d 131, 136; *Gaylord* v. *Commissioner,* 153 F. 2d 408, 414. See also *Krag* v. *Commissioner,* 8 T.C. 1091, 1097.

Moreover, the evidence here overwhelmingly supports the Tax Court's conclusion (R. 239) that the trusts in this case were voluntary. *Touli* defines a voluntary trust as one created without a valuable consideration. The trust instruments themselves (Exs. 5, 6, 20) specifically state in the introduction that the trusts were created "without any consideration." Will Flitcroft testified that he received no consideration (R. 142) and Miers, the trustee, testified that he gave none (R. 191). Furthermore, for the year in which the trusts were created, taxpayers

filed federal gift tax returns (Exs. 29–I and 30–J) and a gift tax return with the State of California (R. 227), a persuasive indication here that they intended to make a gift—that the trusts were created, not for their own benefit, but for their children's.

Despite these facts, taxpayers insist that they created the trusts for the purpose of securing the services of Miers—the trustee—for their partnership business and in support cite (Br. 47) the Tax Court's findings (R. 225–226) that Miers was of great assistance to the partnership. We do not question the value of Miers to the partnership business, but point out that for these services he was paid $60 a day. (R. 187.) Moreover, taxpayers' claim that they gave their children one-half of their partnership business for 10 years and ownership of property and a lease on which the partnership building was located, to obtain the services of Miers as trustee for the partnership business (especially in light of the minimal compensation he was to receive *as trustee* (Art. VI, Exs. 5, 6, 20)), strains credulity far and above its breaking point. The claim also is inconsistent with the testimony of Will Flitcroft that he made Miers trustee because he "thought he would be a real good man to have as trustee for my children. He had an interest in my children." (R. 132.) The Tax Court, therefore, soundly rejected taxpayers' claim and instead reached the sensible conclusion (R. 239) that these trusts were created for the benefit of taxpayers' children, were without consideration, and therefore were revocable under California law. *Title Ins. & Trust Co.* v. *McGraw,* 72 Cal. App. 2d 390, 164 P. 2d 846; *Gaylord*

v. *Commissioner, supra; Newman* v. *Commissioner, supra.*

2. Taxpayers next urge (R. 52) that, if the two single trusts were revocable when created, they were reformed and made irrevocable from the date of their execution pursuant to a state court judgment. (Ex. 13), a judgment, which, they also urge, is binding upon the federal courts.[3] Contrary to taxpayers' claim, however, the judgment they secured is not binding upon the federal courts since, as the Tax Court found (R. 240) and as the evidence shows, this state court judgment was collusive.

First of all, the only significant reason for taxpayers' securing the order of reformation more than 7 years after they were informed that their trusts were not irrevocable under California law (Ex. 31–K), notwithstanding their protestations and their suggestion of other possible, but not persuasive, reasons, was to try to reduce their federal tax liability. This was especially true once the District Director succeeded in having himself dismissed as a party to the suit, after which all the parties in control of the litigation were seeking the same result. Secondly, the complaint in the suit, to which, as the state court declared (Ex. 13), no sufficient answer was made, alleged that reformation was necessary because the scrivener mistakenly omitted from the trust instru-

[3] There is no evidence in this case that the joint trust was ever reformed by a state court judgment. It was amended on July 30, 1954 (Ex. 21), but, as we have already explained, this amendment and the amendments of the two other trusts on the same date (Exs. 7, 8, 21) do not enable taxpayers to escape the effect of Section 673(a).

ments the sentence: "This trust is irrevocable" (Ex. 11, p. 10). Yet, when taxpayers were first informed by the California state comptroller's office that the trusts were not irrevocable because of Section 2280 of the Civil Code (Ex. 31–K), their attorney replied (Ex. 32–L):

> When the trusts were prepared and executed by the Donors consideration was not given to the effect of Section 2280 of the Civil Code.

Since Section 2280 requires that a trust expressly state that it is irrevocable, this statement of taxpayer's attorney is difficult to reconcile with the allegation in their complaint that the scrivener mistakenly omitted this key phrase. When this inconsistency is considered together with the anticipated tax savings attributable to the trusts, the late date at which the order of reformation was secured, and the fact that the judgment was rendered on the pleadings without hearing (Ex. 13), it becomes perfectly clear that the judgment secured was in the nature of a consent decree and, as this Court has explained in an earlier case involving another belated attempt of grantors of a trust governed by California law to reform their trust instrument (*Newman* v. *Commissioner,* 22 F. 2d 131, 136)—

> was collusive in the limited and special sense that all parties joined in the submission of the issues and sought a decision which would adversely affect the tax rights of the government.

Such an order, this Court held, is not binding on a federal court. See also, *Wolfsen* v. *Smyth,* 223 F. 2d 111, 113–114 (C.A. 9th), certiorari denied, 352 U.S.

878; *Faulkerson's Estate* v. *United States,* 301 F. 2d 231, 232–233 (C.A. 7th), certiorari denied, 371 U.S. 887; *In re Sweet's Estate,* 234 F. 2d 401, 404 (C.A. 10th). Certainly, in light of the evidence outlined in the preceding paragraph, the Tax Court's resolution of this factual question (*Merchants National Bank & Trust Co.* v. *United States,* 246 F. 2d 410, 417 (C.A. 7th), certiorari denied, 355 U.S. 881, rehearing denied, 355 U.S. 920) was not clearly erroneous (*Commissioner* v. *Duberstein,* 363 U.S. 278, 291).

Taxpayers seek to counter the Tax Court's finding of collusiveness in the state court proceedings with two arguments. First, they point out that the suit was brought as an action for a declaratory judgment under Section 1060 of the Code of Civil Procedure, 18 West's Annotated California Codes, Appendix, *infra.* Because Section 1060 requires that there be an actual controversy before the court can render a declaratory judgment, taxpayers argue that the very fact that the state court did render judgment proves conclusively the existence of a *bona fide* adversary proceeding. The question, however, of whether there was an actual controversy was not raised in the state court proceeding and consequently was never passed upon. Moreover, as we have already demonstrated, there was no *bona fide* dispute between the parties here, with one side opposing the position of the other, as required by California decisions. See, *Maxwell* v. *Brougher,* 99 Cal. App. 2d 824, 828, 222 P. 2d 910, 922; *Gillies* v. *LaMesa Etc. Irr. Dist.,* 54 Cal. App. 2d 756, 762, 120 P. 2d 941, 944. Thus, the fact that the state court did render judgment in a suit brought

for declarative relief does not, in the circumstances of this case, prove the existence of a *bona fide* adversary proceeding.[4]

Taxpayers also urge (Br. 52–54) that their suit was a suit for reformation which did not require a *bona fide* adversary proceeding since it was instituted only to correct a mutual mistake. But the reformation cannot occur in such a way as to defeat the already accrued rights of a third party—in this case the United States. Here the reformation order was granted in November, 1961, long after taxpayers' tax liability on the income of the trusts in 1954, 1955, and 1956 had become fixed. Insofar as the order adversely affected the tax rights of the Government, the Tax Court properly refused to give it effect. *M. T. Straight's Trust* v. *Commissioner,* 245 F. 2d 327 (C.A. 8th); *Sinopoulo* v. *Jones,* 154 F. 2d 648 (C.A. 10th).[5]

3. As a last resort, taxpayers claim (Br. 35) that Section 673(a) of the 1954 Code, and Treasury Regulations 118 (1939 Code), Sec. 39.22(a)–21(c), Appendix, *infra,* are unconstitutional. In so doing, they

[4] This is so notwithstanding Section 1061 of the California Code of Civil Procedure, under which a court may dismiss a suit for declaratory judgment if it is premature. The language of this section is permissive and in no way requires a California court to raise, on its own accord, the issue of whether there is an actual controversy.

[5] Section 3399 of the Civil Code, 12 West's Annotated California Codes, cited by taxpayers as supporting their claim for retroactive reformation (Br. 52–54), is not applicable because it refers to a "written contract". The voluntary trusts in this case (Exs. 5, 6, 20) were not written contracts. *Gaylord* v. *Commissioner*, 153 F. 2d 408, 415 (C.A. 9th).

rely on *Commissioner* v. *Clark,* 202 F. 2d 94 (C.A. 7th). The *Clark* case, however, is readily distinguishable from this case. As a preliminary matter, the court in *Clark, supra,* p. 98, held that the trusts in that case were 10-year trusts. Thus, the court had no need to examine the validity of the Regulations. Furthermore, in *Clark,* the Commissioner was applying the Clifford Regulations,[6] which were promulgated on December 29, 1945, and made applicable to taxable years commencing January 1, 1946, to trusts created before the Regulations came into existence. The Court of Appeals for the Seventh Circuit refused to allow this retroactive application. In the instant case, however, the Clifford Regulations, more particularly, Treasury Regulations 118 (1939 Code), Sec. 39.22(a)–21(c), had already been in existence for 7 years when the three trusts were created. Consequently, there was no retroactive application.[7]

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[6] More specifically, the Commissioner was relying on Treasury Regulations 111 (1939 Code), Sec. 29.22(a)–21(c), as added by T.D. 5488, 1946–1 Cum. Bull. 19, a regulation identical to Treasury Regulations 118 (1939 Code), Sec. 39.22(a)–21(c).

[7] By distinguishing the *Clark* case on this basis, however, we are not conceding that the Commissioner cannot constitutionally apply retroactively either the Clifford Regulations under the 1939 Code or the special trust provisions of the 1954 Code to trusts created before the Regulations were promulgated or the short-term provisions of the 1954 Code were enacted. For cases in which such retroactive application has been approved, see *Kay* v. *Commissioner*, 178 F. 2d 772, 773 (C.A. 3d); *Shapero* v. *Commissioner*, 165 F. 2d 811, 812 (C.A. 6th).

We also wish to point out that the *Clark* case involved a charitable trust. With respect to the liability of grantors on the income of Clifford trusts, charitable trusts have generally received special consideration from the courts (*Helvering* v. *Bok*, 132 F. 2d 365, 367 (C.A. 3d), and *Commissioner* v.

Moreover, for all but one year of one of the trusts—the income of the joint trust for the fiscal year December 1, 1953, to December 1, 1954—the Commissioner was asserting his tax under a statute passed by Congress in 1954 to income earned by trusts in 1954, 1955, and 1956. The fact that this statute was applied to trusts created before it was enacted and to income earned by the trusts in 1954 prior to its enactment does not adversely affect its validity. *Reinecke* v. *Smith,* 289 U.S. 172, 175.

It is true that as dictum in *Clark,* the Court of Appeals for the Seventh Circuit did express its view, that even in the absence of retroactivity, the regulation and even a statute (though at the time of the decision in *Clark* on February 19, 1953, Section 673(a) had not been enacted) automatically taxing to the settlor the income of a less-than-10-year-reversionary-trust was unconstitutional. With this view we respectfully disagree. Even prior to the promulgation by the Treasury of the Clifford Regulations, the Commissioner had taxed the income of short-term trusts to the settlor and been upheld by the Supreme Court in *Helvering* v. *Clifford,* 309 U.S. 331, and *Harrison* v. *Schaffner,* 312 U.S. 579, and by the courts of appeals in such cases as *Cory* v. *Commissioner,* 126 F. 2d 689 (C.A. 3d), and *Commissioner* v. *Berolzheimer,* 116 F. 2d 628 (C.A. 2d), the latter two cases involving trusts of nearly 10 years duration.

Admittedly the Supreme Court in the *Clifford* case did explain that to decide whether the grantor of a

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Chamberlin, 121 F. 2d 765, 766 (C.A. 2d)) and from the Congress (Section 673(b) of the 1954 Code).

trust was taxable on its income no one factor was determinative. It is significant, however, that in its opinion in the *Clifford* and *Schaffner* cases, the Supreme Court specifically invited either the Treasury or the Congress to lay down precise standards or guides for solving the problem. *Helvering* v. *Clifford, supra,* pp. 334–335; *Harrison* v. *Schaffer, supra,* pp. 583–584. In this invitation, the Supreme Court did not in any way indicate that Congress or the Treasury would have to formulate rules in terms of rebuttable presumptions, the absence of which made the regulation unconstitutional in the eyes of the Seventh Circuit. *Clark* v. *Commissioner, supra,* pp. 99–100. Rather, the invitation suggested the need for fixed rules so as to avoid the necessity of a case-to-case examination by the judiciary.

Both the Treasury and the Congress ultimately accepted the invitation of the Supreme Court, the Treasury late in 1945 and the Congress in 1954. Both selected a 10-year period as the minimum duration of an irrevocable reversionary trust to permit the grantor to escape taxation on the income of the trust. The length of the period they chose was consistent with the decisions of two courts of appeals upholding the taxation of grantors on the income of trusts to endure 10 years, *Cory* v. *Commissioner, supra; Commissioner* v. *Berolzheimer, supra.* Moreover, as the Supreme Court has explained in *Burnet* v. *Wells,* 289 U.S. 670, 678–679, a case involving the constitutionality of a statute taxing the grantor on the income of trusts set up to pay for insurance policies on the life of the grantor: "A margin must be allowed for the

play of legislative judgment." Evidently, both the Treasury and the Congress believed that a period of less than 10 years was too short to permit a grantor of a short-term reversionary trust to escape taxation on its income. This Court should not overrule their combined judgment.

CONCLUSION

For the reasons given, the decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted.

JOHN B. JONES, JR.,
Acting Assistant Attorney General.
MEYER ROTHWACKS,
EARL J. SILBERT,
Attorneys,
Department of Justice,
Washington, D.C., 20530.

AUGUST 1963.

CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of _____, 1963.

_____,
Attorney.

APPENDIX

Civil Code, 10 West's Annotated California Codes:

§ 2216. *Voluntary trust defined*

VOLUNTARY TRUST, WHAT. A voluntary trust is an obligation arising out of a personal confidence reposed in, and voluntarily accepted by, one for the benefit of another.

§ 2280. *Revocation*

Unless expressly made irrevocable by the instrument creating the trust, every voluntary trust shall be revocable by the trustor by writing filed with the trustee. When a voluntary trust is revoked by the trustor, the trustee shall transfer to the trustor its full title to the trust estate. Trusts created prior to the date when this act shall become a law shall not be affected hereby.

Code of Civil Procedure, 18 West's Annotated California Codes:

§ 1060. *Right of action; actual controversy; scope; effect of declaration*

Any person interested under a deed, will or other written instrument, or under a contract, or who desires a declaration of his rights or duties with respect to another, or in respect to, in, over or upon property, or with respect to the location of the natural channel of a water course, may, in cases of actual controversy relating to the legal rights and duties of the respective parties, bring an action in the superior court for a declaration of his rights and duties in the premises, including a determination of any question of construction or validity arising under such instrument or contract. He may ask for a declaration of rights or duties,

either alone or with other relief; and the court may make a binding declaration of such rights or duties, whether or not further relief is or could be claimed at the time. The declaration may be either affirmative or negative in form and effect, and such declaration shall have the force of a final judgment. Such declaration may be had before there has been any breach of the obligation in respect to which said declaration is sought.

§ 1061. *Refusal to exercise power*

The court may refuse to exercise the power granted by this chapter in any case where its declaration or determination is not necessary or proper at the time under all the circumstances.

Internal Revenue Code of 1939:

SEC. 166. REVOCABLE TRUSTS.

Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust shall be included in computing the net income of the grantor.

(26 U.S.C. 1952 ed., Sec. 166.)

Internal Revenue Code of 1954:

SEC. 673. REVERSIONARY INTERESTS.

(a) *General Rule.*—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if,

as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

(b) *Exception Where Income Is Payable to Charitable Beneficiaries.*—Subsection (a) shall not apply to the extent that the income of a portion of a trust in which the grantor has a reversionary interest is, under the terms of the trust, irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary, which beneficiary is of a type described in section 170(b)(1)(A) (i), (ii), or (iii).

* * * * *

26 U.S.C. 1958 ed., Sec. 673.)

SEC. 676. POWER TO REVOKE.

(a) *General Rule.*—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) *Power Affecting Beneficial Enjoyment Only After Expiration of 10-Year Period.*—Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

(26 U.S.C. 1958 ed., Sec. 676.)

SEC. 683. APPLICABILITY OF PROVISIONS.

(a) *General Rule.*—This part shall apply only to taxable years beginning after December 31, 1953, and ending after the date of the enactment of this title.

* * * * *

(26 U.S.C. 1958 ed., Sec. 683.)

Treasury Regulations 118 (1939 Code):

SEC. 39.22 (a)–21 *Trust income taxable to the grantor as substantial owner thereof—*

* * * * *

(c) *Reversionary interest after a relatively short term.* (1) Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment:

(i) Within 10 years commencing with the date of the transfer, * * *

* * * * *

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